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The Real Estate Investment Trust: Legal and Economic Aspects

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THE REAL ESTATE INVESTMENT TRUST: LEGAL AND ECONOMIC ASPECTS

CAROL MACMILLAN STANLEY*

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I. INTRODUCTION

Throughout the history of man, land ownership has been considered an indicator of wealth and status. In addition, our English ancestors, from whom we derive much of our law and customs, instilled in the founders of this country a reverence for land ownership. The requirement in the United States for increasingly vast complexes of buildings at a cost far beyond the means of the majority of individuals, even those with substantial wealth, resulted in group ownership of land by partnerships, syndicates and corporations. In recent years, investment in real estate has become even more attractive as the classic hedge against inflation.

As an investment medium, real estate offers financing through a mortgage. Although interest payments on the mortgage are deductible as business expenses, the tax basis for depreciation includes the portion of the acquisition price financed by the mortgagee.¹ The owner's cash return of depreciable real property consists of gross cash revenues less expenses and mortgage payments. Depreciation, since it is non-cash, does not reduce the cash return received by the owner, although it does

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1. INT. REV. CODE OF 1954, §§ 1012, 1016 [hereinafter cited as IRC].

reduce the taxable portion of such return.² Depreciation also provides a current deduction against ordinary income at the cost of an increase in future potential capital gain—when the property is sold, any gain realized is increased to the extent of depreciation deductions in prior years because of commensurate reductions in basis.³

Consequently, an owner can receive a cash return and yet be entitled to a net loss for tax purposes which can be offset against his other income.⁴ This result can be planned by use of accelerated depreciation in the early years of ownership.⁵

The consideration of a new real estate venture, or the reorganization of an existing one, raises the question of which form of business organization is to be used. The objectives of the investor, including the solution of business and tax problems, must be taken into consideration. The business problems, of course, must be given primary consideration. They include (a) centralization of management to the greatest possible extent; (b) single titleholding entity uninterrupted by death; and (c) limitation of liability where possible. The tax objectives include (a) income taxed at the lowest rate; (b) avoidance of double taxation; (c) capital gains on the sale of property; (d) tax-free return of investment at the earliest possible date and to the largest extent; (e) repayment of investment prior to sharing of profits; (f) the number of participants, who they are, and their individual tax brackets; and (g) the nature of the business investment.⁶

Element (g) above, the nature of the business investment, is of particular importance because it will necessarily determine how the other factors will be handled. Most business forms today are statutorily regulated.

The purpose of this article is to familiarize the reader with one particular type of business investment—the Real Estate Investment Trust (hereinafter referred to as REIT), as codified by the Internal Revenue Code.⁷ For certain groups, this form of real estate ownership may well provide a solution to the above mentioned business and tax problems.

II. GENERAL BACKGROUND OF THE REIT

The basic purpose of the REIT is to grant to customary types of real estate trusts substantially the same type of conduit treatment for federal income tax purposes on income from real estate investments as

2. IRC §§ 167, 1016(a)(2).

3. IRC §§ 167, 1016.

4. *Id.*

5. Albon, *Real Estate Investment Trusts and Alternate Forms of Investment*, 7 *PRAC. LAW.* 13 (1961).

6. Goldworn, *Tax Consequences of Multiple Owner Real Estate Investment*, 40 *CHL.-KENT L. REV.* 125 (1963).

7. IRC §§ 856-58.

had been available to regulated investment companies by sections 851 through 855 of the Internal Revenue Code with respect to income from stocks and bonds.⁸

In considering the passage of this legislation, the House Ways and Means Committee reported:

[T]hus this secures for the trust beneficiaries the same type of tax treatment they would receive if they held the real estate equities and mortgages directly and, therefore, equates their treatment with that accorded investors in regulated investment companies. . . . In both cases the methods of investment constitute pooling arrangements whereby small investors can secure advantages normally available only to those with larger resources. These advantages reward spreading the risk of loss by the greater diversification of investment which can be secured through the pooling arrangement; the opportunity to secure the benefits of expert investment counsel; and the means of collectively financing projects which investors could not undertake singly. . . . Your committee believes it is also desirable to remove taxation to the extent possible as a factor in determining the relative size of investment in stocks and securities on one hand and real estate equities and mortgages on the other.⁹

From the legislative history, it is apparent that only passive investment income is entitled to conduit treatment,¹⁰ that only income from a trust deriving most of its income from real estate and interests in real estate is entitled to conduit treatment,¹¹ and that the trust must observe rules similar to those required of regulated investment companies.¹²

In spite of the intent to grant real estate investors the same tax

8. *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954), held that organizations of doctors could qualify as associations, thus making it possible to set up qualified pension plans. Real estate syndicators seeking to avoid classification as a corporation resisted the professional groups in order to avoid a tax impact on their own operations. The regulations proposed by the Treasury Department subsequent to *Kintner* were contrary to the realtors' interests by reason of its treatment as corporations of real estate organizations which had previously been operating as limited partnerships. As a result, the REIT concept was passed by Congress. Thereafter, however, the final "Kintner Regulations" (Treas. Reg. § 301.7701 (1960)) were passed, resulting in a reversal of the proposed regulations. The real estate men again had the regulations in their favor; they provided that an organization will not be taxed as a corporation unless it has more corporate characteristics than non-corporate characteristics. Among these characteristics are associates and a business-for-profit objective (common to both partnerships and corporations), continuity of life, centralized management, limited liability, and transferability of shares (uniquely corporate characteristics). See Note, *The Real Estate Investment Trust—Past, Present, and Future*, 23 U. PITT. L. REV. 779 (1962).

9. HOUSE COMM. ON WAYS AND MEANS, H.R. DOC. NO. 12559, 86th Cong., 2d Sess. 10960 (1960).

10. Post & King, *Final REIT Regulations Adopted; The Changes and the Effects*, 17 J. TAX. 54 (1962).

11. IRC § 856(c)(2), (3); Treas. Reg. § 1.856-2(c) (1962) [hereinafter cited as Reg.].

12. IRC §§ 851-55.

treatment as that granted regulated investment companies, Congress failed to distinguish the patent differences between investments in real estate and in securities.¹³ Realty trusts generally derive their income from rents and mortgages, the investment companies from dividends and interest on corporate bonds. Dividends are paid from corporate income after payment of the corporate tax by the distributing corporation. Moreover, the tax on dividends received by a corporation from stock held in another corporation is only 15 percent of the income.¹⁴ However, a major portion of the income of regulated investment companies is taxed prior to distribution to the investment company. The tax conduit provision pertaining to dividends costs the government a maximum of 7.2 percent of the dividend income of the regulated investment company (48 percent¹⁵ of 15 percent¹⁶ or less if income is less than \$25,000).¹⁷ Commissions, rents, and interest on mortgages are expenses of taxpayers which are fully deductible¹⁸ and taxable as income to the corporate recipients.¹⁹ There is only single taxation to the trust beneficiary because the conduit provision allows this income to completely escape the corporate tax if it is distributed in the year received. The REIT, therefore, results in a greater tax benefit than the Regulated Investment Company. The realty trust conduit is costing the government 48 percent on all the distributed income of the trust.²⁰ (The government's cost is 22 percent if corporate taxable income does not exceed \$25,000.)²¹

The primary advantages which the REIT affords investors are: expert counsel; safety of investment; little or no tax on the trust itself; and diversification with respect to number, type, and location of investments.²²

There are two basic types of REITs—equity trusts and mortgage trusts. Equity trusts are primarily engaged in the ownership of all categories of real property, which may or may not be subject to encumbrances. Their main source of income is from rentals. Mortgage trusts, on the other hand, invest their assets in long or short term mortgages or other liens against real property. The mortgage trusts' income is derived principally from interest earned on the mortgages and from discounts and commissions on mortgage purchases.²³

13. Note, *The Real Estate Investment Trust—Past, Present, and Future*, 23 U. PITT. L. REV. 779 (1962).

14. IRC § 243(a). See generally IRC §§ 241-47.

15. IRC §§ 11(b)(2), 11(c)(3), and 11(d) (22% normal tax on first \$25,000 of income plus an additional 26% on the excess).

16. IRC § 243(a).

17. IRC § 11(d). See Note, *Real Estate Investment Trusts—Equalization of Investment Opportunity or Unjustified Tax Break to Favored Interests*, 1961 WASH. U.L.Q. 436.

18. IRC § 212.

19. IRC § 61.

20. IRC § 857(b).

21. IRC § 11(d).

22. 4 P-H FED. TAX-1969 ¶ 29,820, at 29,794; see Note, 1961 WASH. U.L.Q. 436.

23. NATIONAL ASSOC. OF REAL ESTATE INVESTMENT FUNDS, *REAL ESTATE INVESTMENT OPPORTUNITIES WITH DIVERSITY AND LIQUIDITY* (1969) (pamphlet of limited circulation).

III. QUALIFYING REQUIREMENTS OF THE INTERNAL REVENUE CODE

A. Status

Except for the REIT provisions, a real estate association could be taxed as a corporation²⁴ if it met the criteria of the Kintner Regulations.²⁵ These regulations describe a number of major characteristics which, taken together, distinguish a true corporation from other associations. These are: (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for corporate debts limited to corporate property, and (6) free transferability of interests. To escape this corporate qualification and the resultant imposition of double taxation the realty association must therefore adhere strictly to the statutory requirements. For example, the REIT must be unincorporated²⁶ and must be managed by one or more trustees.²⁷ The trustee or trustees must hold legal title to the property of the REIT and have such rights and powers, according to the Kintner requirement, as results in centralization of management.²⁸ The trustee(s) must have exclusive authority over the management of the trust, the conduct of its affairs, and the management and disposition of the property.²⁹

The beneficial ownership of the trust must be represented by transferable shares or certificates of such interest and must be held by 100 or more persons.³⁰ Even though the shares are transferable, however, the trustee may retain the power to refuse to transfer shares in order to maintain the requirements of REIT status.³¹

Although the language of the Code does not use the word "passive," this requirement is deduced from the rule that a REIT may not hold any property primarily for sale to customers in the ordinary course of business.³² Whether or not property is held primarily for sale to customers depends on an interpretation of the facts and circumstances in each case.³³

The qualified REIT must not also qualify as a section 542 personal

24. IRC § 856(a)(3).

25. Reg. § 301.7701-2(a)(1) (1960). See note 8 *supra*.

26. IRC § 856(a).

27. IRC § 856(a)(1).

28. Reg. § 301.7701-2(c); see note 25 *supra*. In addition, a trustee of a real estate investment trust may be an officer or an employee of, or have a direct or indirect proprietary interest in, an independent contractor which confines its activities to the servicing of real estate mortgages owned by the trust. Rev. Rul. 65-65, 1965 CUM. BULL. 267.

29. Reg. § 1.856(d)(i). According to Rev. Rul. 64-259, 1964-2 CUM. BULL. 268, a trust will not fail to qualify as a real estate investment trust solely because one of its trustees is a stockholder, officer, or employee of an organization which renders legal or investment advisory services to the trustees.

30. IRC § 856(a)(2), (5); Reg. 1.856-1(2). This produces a broadly-based association for the small investor.

31. Reg. § 1.856-1(2).

32. IRC § 856(a)(4); Reg. § 1.856-1(d)(4).

33. Reg. § 1.856-1(d)(4).

holding company.³⁴ Thus, if more than half of the value of the REIT's outstanding stock is owned directly or indirectly by five or less individuals, the association would qualify as a personal holding company but not as a REIT.³⁵

B. *Income Requirements*

According to section 856(c), 75 percent of gross income must be derived from rents from real property, gain from the sale or other disposition of transferable shares (or transferable certificates of beneficial interest) in other real estate investment trusts which meet all requirements, and abatement and refunds of taxes on real property.³⁶

Another 15 percent of gross income must be derived from dividends, interest, rents from real property, and gain from the sale or other disposition of stock, securities, and real property (including interests in real property, interests in mortgages on real property, and abatement and refunds of taxes on real property).³⁷ A maximum of 10 percent of gross income is not restricted as to source.³⁸

Less than 30 percent of the gross income can be from sales of stock or securities held for less than six months and real property held for less than four years (excluding involuntary conversions).³⁹ It must be noted that loss from the sale or other disposition of property subject to this 30 percent limitation is not netted with gain from the sale or other disposition of such property.⁴⁰

C. *Asset Requirements*

At the close of each quarter of the taxable year at least 75 percent of the value of the total assets of the trust must be represented by one or more of the following: real estate assets, cash and cash items (including receivables), and government securities.⁴¹ The receivables must not include those purchased from another person, but must arise in the

34. IRC § 856(a)(6).

35. Reg. § 1.856-1(d)(5).

36. IRC § 856(c)(3). This requirement, together with the 15 percent requirement of § 856(c)(2), may prove unduly burdensome if a particular acquisition requires the trustee to take title to personal property along with real estate. *See* Note, 1961 WASH. U.L.Q. 436.

37. IRC § 856(c)(2).

38. Reg. § 1.856(c)(1)(b).

39. IRC § 856(c)(4). This section limits the REIT's short-sales and strengthens its non-dealer status; therefore, promoters looking for quick return of capital by use of accelerated depreciation and frequent sales of property will continue to use the corporate method of business. Even 30 percent in short-term assets, however, could throw the REIT within the collapsible corporation provisions of § 341.

40. IRC § 856(c)(5)(A).

41. IRC § 856(c)(5)(A). Included in the definition of government securities are the securities of the Federal Housing Administration, the Federal National Mortgage Association, the Federal Home Loan Bank, the Federal Land Bank, Federal Intermediate Credit Banks, Banks for Cooperatives, and the Public Housing Administration. Rev. Rul. 64-85, 1964-1 CUM. BULL. 230.

ordinary course of the trust's operation.⁴² The character of the remaining 25 percent of the value of the total assets is not restricted. The ownership of securities under the 25 percent limitation is limited to an amount not greater in value than 5 percent of the value of the total assets, and to not more than 10 percent of the outstanding voting securities of any one issue.⁴³

The complexity of the above requirements is slightly alleviated by the provision that if a discrepancy exists immediately after the acquisition of any security or other property which is wholly or partly the result of such acquisition, the REIT shall not lose its status for such quarter; but the discrepancy must be eliminated within thirty days after the close of such quarter in order to qualify for REIT treatment during such quarter.⁴⁴

D. Rents from Real Property and the Independent Contractor

Section 856(d) and the regulations pertaining thereto give special, detailed treatment concerning "rents from real property." Rents from real property, as required by the 90 percent and 75 percent gross income tests of section 856(c), generally means the gross amounts received for the use of, or the right to use, real property of the REIT. Apportionment is required where rent may also be received for personal property such as furnishings.⁴⁵ Any amount of rent which depends in whole or in part on the income or profits derived by any person from such property must also be excluded.⁴⁶ This, however, does not necessarily preclude use of a fixed percentage⁴⁷ or an escalator provision.⁴⁸ Nevertheless, any arrangement devised must conform with normal business practices and is not to be used as a means of basing the rent on income or profits.⁴⁹

Also excluded from rents of real property is any amount received from a corporation in which the REIT owns 10 percent or more of the voting stock.⁵⁰ If the REIT receives rent from a non-corporate entity and the trust owns a 10-percent or more interest in its assets or net

42. Reg. § 1.856-2(d)(2).

43. IRC § 856(c)(5)(B).

44. IRC § 856(c).

45. IRC § 856(d)(1).

46. *Id.*

47. Reg. § 1.856-4(b)(1). Rents paid by a shopping center tenant based on a fixed percentage of gross sales or receipts from merchandise sold or service rendered on any part of the premises qualify as rents from real property even though the tenant received a portion of the net income of a sublessee according to Rev. Rul. 66-379, 1966-2 CUM. BULL. 279.

48. Rev. Rul. 64-50, 1964-1 (Part 1) CUM. BULL. 231. This provision may place an onerous burden on large operations which is out of proportion to the passivity requirement. See note, 23 U. PITT. L. REV. 779 (1962).

49. *Id.*

50. IRC § 856(d)(2)(A).

profits, the rent does not qualify.⁵¹ Moreover, any amount received with respect to any real property from which the REIT receives money as a result of its furnishing services to the tenants is also excluded.⁵² The income will qualify as rent from real property only if an independent contractor manages or operates the property and the REIT receives no dividend therefrom.⁵³ This applies only to customary services for which no separate charge is made.⁵⁴

An independent contractor is defined as a person or a corporation who does not own more than 35 percent of the shares in the REIT.⁵⁵ Likewise, a 35-percent owner of the REIT must not have more than a 35-percent interest in the independent contractor.⁵⁶

IV. TAXATION OF THE TRUSTS AND SHAREHOLDERS

A. *Taxation of the Trust*

The special tax benefits applicable to the REIT are not available unless the trust pays to its shareholders dividends in the amount of 90 percent of its REIT taxable income for such taxable year,⁵⁷ and the trust complies with certain record-keeping requirements.⁵⁸ If the association fails to meet the requirements for the taxable year, it will be subject to tax as a corporation, regardless of its classification.⁵⁹

After deducting dividends paid, the REIT is subject to the imposition of the normal tax and surtax as prescribed by section 11.⁶⁰ This figure is computed without reference to capital gains dividends.⁶¹ A tax of 25 percent for each taxable year is placed on the excess, if any, of

51. IRC § 856(d)(2)(B).

52. IRC § 856(d)(3).

53. *Id.*

54. IRC § 856(d)(3); Reg. § 1.856-4(b)(3)(b). For services for which a charge is made, no income from such charge may inure to the trust. Reg. § 1.856-4(b)(3)(c). But putting the burden of repair on the independent contractor is unrealistic, since it will cut into his profits.

55. IRC § 856(d)(3)(A), (B).

56. IRC § 856(d)(3); Reg. § 1.856-4(b). The original prohibition of a trustee being an officer or employee of, or having any direct or indirect proprietary interest in, any independent contractor rendering services to the trust property was removed from the regulations in 1967.

57. IRC § 857(a)(1).

58. IRC § 857(a)(2). The REIT is required to keep such records as will disclose the actual ownership of its outstanding stock. If the trust has 200 or less shareholders, a statement is required only from those shareholders of one-half of 1 percent or more of its stock. If the trust has between 200 and 2,000 shareholders, statements are required of each record holder of 1 percent or more of its stock. In case there are 2,000 or more shareholders, statements are required of each holder of 5 percent or more of its stock. The purpose of such statements is to disclose the beneficial ownership of the stock. If the trust fails to keep such records, it shall be taxable as an ordinary corporation and not as an REIT. Reg. § 1.857-6.

59. Reg. § 1.857-1(b). Since mortgage payments are not deductible, in theory the principle payments on a large mortgage could prevent the trust from meeting the distribution requirement. See Note, 1961 WASH. U.L.Q. 436.

60. IRC § 857(b)(1).

61. IRC § 857(b)(1); Reg. § 1.857-2(a).

net long-term capital gain over the sum of its net short-term capital loss and its deduction for dividends paid (determined with reference to capital gains dividends only.)⁶²

B. *Taxation of Shareholders*

As stated above, long-term capital gains are taxed as in the case of an ordinary corporation at 25 percent, except that to the extent the trust designates any dividend or part thereof as a capital gain dividend, the shareholders rather than the trust are taxed on the long-term capital gain.⁶³ Notice to shareholders of the amount of any capital gain dividends must be given within thirty days after the year of payment.⁶⁴

Where a share or interest in a REIT is held for thirty days or less, any loss on the sale or exchange of the share or interest, to the extent of any capital gain dividend received in the thirty-day period, is a long-term capital loss.⁶⁵

The REIT trustees are permitted a twelve-month period after the taxable year closes to pay to the shareholders additional dividends; provided, however, that the declaration thereof occurs before the time for filing the return.⁶⁶

V. OPERATIONAL CONSIDERATIONS

A. *Federal Regulations*

As of October 28, 1968, sixty-one REITs had made at least one public offering by registering with the Securities and Exchange Commission.⁶⁷ These REITs boasted assets of more than one billion dollars.⁶⁸ A REIT cannot qualify for a private offering since there must be at least one hundred participants.⁶⁹ It may qualify for the intrastate offering exemption, however, if it constitutes an investment company required to be registered under the Investment Company Act of 1940.⁷⁰ This exemption provides that the trust will not be required to register under the act if it invests exclusively in fee interests in real estate or mortgage or liens secured by real estate, and is not engaged in the business of issuing face amount certificates of the installment type or pe-

62. IRC § 857(b)(3)(A); Reg. § 1.857-2(b).

63. IRC § 857(b)(3); Reg. § 1.857-4(b).

64. IRC § 857(b)(3)(C).

65. IRC § 857(b)(4); see Reg. § 1.857-4(c)(3) for examples.

66. IRC § 858(a). According to section 858(b), however, the shareholders shall include such dividend in the taxable year when received. This section allows adjustments by the REIT in order to meet the 90-percent dividend deduction requirement of section 857(a)(1).

67. Thomas, *Fresh Appraisal, Real Estate Investment Trusts Regain Favor on Wall Street*, BARRON'S, Oct. 28, 1968, at 48, col. 1.

68. *Id.*

69. IRC § 856(a)(5); SEC Release (Nov. 18, 1960).

70. Investment Company Act of 1940 § 3(c)(6)(c), 15 U.S.C. § 2(D) (1964).

riodic payment plan certificates.⁷¹ A trust which invests to a substantial extent in securities of other real estate investment trusts or companies engaged in the real estate business or in other securities might not qualify under this exemption.⁷²

B. State Laws

The REIT cannot be used if the state law does not recognize such a form, or at least does not recognize it for the holding of realty or the collection of rentals. Despite the fact that state law may preclude a business trust from going into some jurisdictions, an interstate operation can still be carried on in other jurisdictions. For example, Florida Statute section 609.02 (1967), while not specifically referring to the REIT, requires that every organization which intends to sell or offer for sale any shares or other security must file a copy of the "declaration of trust" in the office of the secretary of state and pay a fee of \$150.⁷³ The Florida statutes further require businesses organized within this state, as well as those organized elsewhere but seeking to do business within this state, to comply.⁷⁴ After complying with the filing requirement, the association doing business under a declaration of trust must procure from the Florida Securities Commission a permit to offer for sale and sell such securities. In such case, the same conditions applicable to corporations shall be applied.⁷⁵ The Florida Blue Sky Laws⁷⁶ will therefore govern the REIT seeking to do business in Florida. For the purpose of taxation, the shares are considered personal property rather than interests in land unless specifically provided otherwise in the trust instrument.⁷⁷

Thus it can be seen that trusts which seek to sell their shares in their own and in other states must familiarize themselves with the applicable state securities laws.

C. Conduit Theory

The REIT is only the conduit, *i.e.*, the funnel through which each individual certificate holder receives income and pays his own tax, just as a partnership is a conduit through which each partner pays his own tax. Neither the trust nor the partnership, that is, the conduits themselves, are taxed.⁷⁸ While a holder of a trust certificate does not receive

71. *Id.*

72. Albon, *supra* note 5.

73. FLA. STAT. § 609.01 (1967) grants to two or more persons, whether residents of Florida or not, the privilege of organizing for the purpose of transacting business in Florida under a "declaration of trust." It is this writer's opinion that this would be applicable to an REIT.

74. FLA. STAT. §§ 609.02, 609.04 (1967).

75. FLA. STAT. § 609.05 (1967).

76. FLA. STAT. ch. 517 (1967).

77. FLA. STAT. § 608.051 (1967).

78. IRC §§ 701, 857(a).

the dividend credit and exclusion that he would obtain with a stock certificate, this is a small price to pay when the corporate tax is avoided. If capital gain is passed to the holder or the beneficiary of the certificates, it is taxable to them as capital gain.⁷⁹ The tax-free flow available by reason of depreciation may be passed on to the beneficiary without immediate tax impact,⁸⁰ but whether this is in fact done is a policy decision to be made by the trustees. It may be wiser to use this cash flow for reinvestment rather than distribution.

In addition, the trust offers the same degree of limited liability formerly possessed by the corporation but denied to the general partnership.

The trustee's accountability may also vary from the common law partnership. Normal trust beneficiaries can require the trustee to account in court, regardless of any showing of malfeasance. His personal liability is only terminated when he resigns or dies, unless he obtains a release by court order following an accounting. In addition, the common law trustee can delegate neither authority nor discretion. The REIT trustee, however, is *required* to delegate his authority to the independent contractor in charge of management of individual properties.⁸¹

There is also a possible conflict of interest where the trustee is involved in a real estate venture alone. The question then arises whether he may take advantage of opportunities on his own account, instead of offering them to the REIT. This situation may be somewhat analogous to the duty owed by an officer or director to his corporation. These problem areas have yet to be settled. Until they are, the trust agreement should provide for them in detail so that no misunderstandings will occur.⁸²

D. Permitted Activity

The misconception that the REIT must have "passive income" has deterred many realtors from considering the REIT. The word "passive" does not actually appear in the code or regulations.⁸³ There are also certain activities which, according to lay usage, would be considered "active," but which are not so considered within the terminology of the Code. Such activities include the construction of buildings on property with the participation of outside contractors, architects, and engineers, and ownership of an office building as long as an independent contractor is employed to manage it. As to the latter, the independent contractor must employ all of the building's employees on its own payroll, even though the trust has a right to pay the contractor on a "cost-plus" basis for his services. The price, of course, must be reasonable.

79. IRC § 857(b)(3)(B).

80. Note, *The Real Estate Investment Trust—Past, Present, and Future*, 23 U. PITT. L. REV. 779 (1962).

81. IRC § 856(d)(3).

82. *Id.*

83. IRC § 856(a)(4), Reg. § 1.856-1(d)(4).

The prohibition of a 35-percent cross-identity of ownership must be observed.⁸⁴ Moreover, because of the amendment to permit trustees to be officers or directors of the independent contractor, there can now be a close working relationship between the trustee and the managing agent.⁸⁵

VI. REIT AND OTHER FORMS OF REALTY GROUP OWNERSHIP

After the passage of the REIT provisions in September, 1960, three basic types of operations began qualification proceedings. These were the publicly held real estate corporations with vast holdings already acquired, syndicates with prior holdings, and newly formed REITs which used the money from the sale of their stock to purchase property.⁸⁶ Each of these will be discussed separately along with two other possibilities, the land trust and the personal holding company.

A. Corporations

As to the large corporations with real estate holdings accumulated in connection with other businesses or otherwise, little incentive for the implementation of the REIT was required. A restriction in their operations would be more than offset by the conduit tax advantages, unless the existing corporations had a substantial depreciation shelter with which to offset its tax liability.

The corporation could effect the change by transferring its real estate holdings to a trustee in exchange for ownership certificates which would be passed on to shareholders.⁸⁷ If the corporation does other business and is therefore not liquidated, the trust would then lease back the property to the corporation for continued use as before. Complications arise if 10 percent or more of the stock of the corporation is owned by the trust either directly or indirectly under the rules of attribution in section 2318(a).⁸⁸ The leaseback may be ruled out by the 25-percent asset test of section 856(c)(5)(B), since the trust is prohibited from

84. IRC § 856(d)(3)(B). See also Silbert, Hirsch, Rabinowitz & Rubin, *Trusts of Real Estate, A Panel Discussion*, 26 N.Y.U. INST. ON FED. TAX. 357 (1968).

85. T.D. 6928, 1967-2 CUM. BULL. 25.

86. *Report of the Committee on Real Estate Tax Problems, Legislative Recommendations*, 18 A.B.A. SEC. TAX. BULL. 99 (1965).

87. Under Rev. Rul. 67-376, 1967-2 CUM. BULL. 142, a corporation may be reorganized into a trust on a tax-free basis by transferring assets to a trust in exchange for trust certificates of beneficial interest, and then distributing the certificates to its stockholders in liquidation of the corporation. The service ruled that such reorganization is an "F reorganization," a mere change in form or identity. Because the REIT by definition must be an association taxable as a corporation but for the special legislation, the transaction qualifies as a reorganization under IRC § 368.

88. IRC § 856(d)(2) provides that any person who owns as much as 10 percent in value of the beneficial interest of the trust cannot own a 10-percent interest in the lessee entity. The property cannot be leased to any 10-percent shareholder individually nor to any partnership or corporation in which a 10-percent shareholder has as much as 10-percent interest. See 4 P-H 1967 FED. TAX ¶ 29,820, at 29,794 (1969).

owning more than 10 percent of the outstanding voting securities of any issuer.⁸⁹ The receipts would thus not be qualified as rent and would not be includable under the 90-percent income requirement of section 856(c)(2).

The sale-leaseback scheme, if effective, would be particularly attractive to hotel chains, railroads, and mining companies.⁹⁰ The business thereby could improve its cash position, while continuing its operations without change on the same premises under a lease. This arrangement might not be attractive if an essentially non-stockholder trust were contemplated and if the interest expense of borrowing on the property would be less than the rental which would have to be paid on the trust. It would be most favorable in situations where the corporation had exhausted its borrowing capacity, and the property to be sold had been substantially depreciated for tax purposes. This would provide a rental deduction based on current values, and the funds received from the sale could be reinvested to the corporation's advantage.⁹¹

A word of caution is appropriate: the Internal Revenue Service may determine that a sale-leaseback is actually a mortgage. Three provisions should be avoided—terms for repurchase, low rentals which are renewable, and unreasonably high initial term rentals. The tax consequences of a leaseback held to be a mortgage will be a denial of the depreciation deduction.⁹² Another consequence is that the rental deductions will also be denied, except to the extent they represent interest.⁹³ Furthermore, a lease of thirty years or more (including renewals) is considered equivalent to a fee for tax purposes,⁹⁴ an effect which would deny capital loss and limit capital gain to cash received.⁹⁵

Although the REIT may seem to be the large corporation's answer to escape double taxation, there are factors which would dissuade a small promoter from converting to the REIT. By limiting the amount of stock any one person may own, a control problem arises.⁹⁶ The re-

89. See p. 161 *supra*.

90. Albon, *supra* note 5. The deal could also be set up with insurance companies, other financial institutions, or a real estate syndicate. For example, New York investment bankers set up and sold to the public interests in a REIT which bought the Union Commerce Building in Cleveland for over \$25 million, and the trust leased it back to the Union Commerce Bank. 2 TAX COORDINATOR ¶ E.7000, at 20,133 (1968).

91. Gunning & Roegge, *Contemporary Real Estate Financing Techniques: A Dialogue in Vanishing Simplicity*, 3 REAL PROP. PROB. & TRIAL J. 325 (1968). It is also apparent that this determination would probably disqualify the REIT on the basis of the gross income and asset provisions of IRC § 56(c).

92. *Id.* See also Wilson, *Sales and Leasebacks*, 16 SO. CAL. TAX. INST. 149 (1964); IRC § 167.

93. IRC § 856(a)(6). See Note, 23 U. PITT. L. REV. 779 (1962).

94. Reg. § 1.1031(a)-1(b) (1956).

95. Reg. § 301.770-2(c)(4) (1960). *Contra*, Western Constr. Co., 14 T.C. 453 (1950), wherein it was stated that general partners could not be dummies to limit the liability of limited partners. The control factor in the regulations should negate any further litigation. See Goldworn, *Tax Consequences of Multiple Owner Real Estate Investment*, 40 CHI.-KENT L. REV. 125 (1963).

96. See note 28 *supra* and accompanying text.

quirements that the trustee and management company be separate entities, together with the foreclosure of the usual means of expansion because of the mandatory 90-percent distribution requirement, may make it more profitable and practical for a smaller promoter to adopt the corporate form or some modified partnership form rather than contend with the REIT restrictions. The promoter may view the corporate form as more profitable by keeping the property only during the years of high depreciation rates. By this method profits can be kept at a minimum and distribution may be made without immediate tax consequences, since the corporation would have no taxable earnings or profits due to the high amount of deductions. When there has been a sufficient return of capital, the promoter can dissolve the corporation at capital gain rates⁹⁷ or the real estate can be sold and new property acquired. Thus the cycle begins anew.

B. *Syndicates*

A limited partnership is the most common form of real estate syndicate. Such an organization could meet all the requirements of the REIT. The general partners could become the trustees when the general management test of Regulation section 1.856(d)(1) is met by a limited partnership form under the Uniform Limited Partnership Act or similar statute, provided all the interests in the partnership are held substantially by the limited partners.⁹⁸

Real estate syndicates vary in size from two to one thousand members. They usually, but not always, own one parcel of property. They frequently have been employed in the sale-leaseback scheme discussed above.⁹⁹ If the syndicate undertakes any substantial improvements on the property, return from its investment may be greatly delayed.¹⁰⁰

The limitations of the syndicate form of land ownership are that it often lacks diversity of investment, liquidity (due to the absence of a secondary market), and suitability for construction projects. By converting to the REIT form, there may be a possible increase in borrowing capacity, especially where more than one property is owned. Greater use of depreciation can be made because properties can be used to offset each other. Since construction will be less of a problem, diversification can be attained more easily. New sources of funds are available by the use of authorized but unissued stock (directly or by underwriting). Otherwise, the only sources of new funds are the proceeds from the sale of other property and mortgage refinancing.¹⁰¹ Added features are transferability of interests and continuity of ownership.

97. IRC § 1231.

98. Albon, *supra* note 5.

99. See pp. 166-67 *supra*.

100. Albon, *supra* note 5.

101. See, e.g., Elliot, *Fresh Appraisal, The Rewards and Risks in Real Estate Investment Trusts*, BARRON'S, April 5, 1965, at 5, col. 2; "REITs"—\$1 Billion Operation, FINANCIAL WORLD, April 7, 1965, at 123.

However, there is one serious drawback which may greatly reduce the benefits of conversion to an REIT. In 1967, Regulation section 1.351(c)(1) was amended to provide that gain or loss will be recognized where property is transferred to an REIT after June 30, 1967, by one or more persons solely in exchange for stock or securities in such REIT. At the present time, then, a tax-free exchange is available only for corporate parties to a reorganization, but not to a syndicate which does not meet the requirements of a corporation.¹⁰² Since the syndicate qualifies for conduit tax treatment in any event, its disadvantages may seem less burdensome in view of the resulting tax on the transfer and the REIT's more severe requirements.

C. Land Trusts

The similarity between the REIT and the land trust stops with the term "trust." So that no confusion will exist, one should first review the basic elements of the land trust. Sometimes referred to as the Dry Land Trust, or Illinois Land Trust, both legal and equitable title to the realty are conveyed to a trustee. The interest retained by the beneficiary is personalty, thus allowing the beneficiary to retain virtually all of the incidents of ownership. By use of a trust agreement, the beneficiary retains the full powers of control and management. This trust form is created by statute.¹⁰³ Its primary use is to facilitate transfers by a large number of owners. It also protects the title from problems and difficulties which may arise from the affairs of the beneficiaries.¹⁰⁴ The advantages of its use are apparent where a mortgage is sought for the property, where there is a desire to subdivide the property, and where ownership is desired to be concealed.¹⁰⁵

There is the danger, as with all businesses, that the organization of the land trust will be taxed as a corporation by the Internal Revenue Service. The *Kintner* regulations must therefore be carefully considered.¹⁰⁶ Since the status is usually met if there is centralized management, the trust agreement, to avoid corporate tax liability, should provide that all of the beneficiaries must execute letters of direction. No power of attorney should be given to any of the beneficiaries, and no management contract giving unlimited powers to certain beneficiaries should be executed. All decisions relative to the management and operation of the property should be joined in by all the beneficiaries.¹⁰⁷ Therefore, the

102. See Silbert, *supra* note 84.

103. FLA. STAT. § 698.071 (1967). See Note, *The North Dakota Land Trust*, 45 N.D. L. REV. 77 (1968).

104. Note, 45 N.D. L. REV., *supra* note 103.

105. This feature has been abused in slum ownership. But ILL. REV. STAT. ch. 80 § 81 (1966) prevents this abuse by requiring the land trustee to disclose the identity of the beneficiaries within ten days after receiving written notice of the violation of a building ordinance.

106. Reg. § 301.7701 (1960). See note 8 *supra*.

107. Note, 45 N.D. L. REV. 77 (1968), *supra* note 103; Silbert, *supra* note 84. See

land trust is best used for limited purposes and not for the purpose of developing a broadly based, liquid, and diversified real estate investment.

D. *Closely Held Corporations*

Subchapter S corporations are designed only for corporations of 10 or less shareholders¹⁰⁸ and hence cannot qualify as REITs.¹⁰⁹ But the REIT may have an indirect benefit to closely-held corporations by making it more attractive for such corporations to sell their property on a sale-leaseback basis to an REIT—especially those properties that have appreciated in value and have been substantially depreciated for tax purposes. These corporations may be subject to additional tax under the personal holding company provisions, the basic purpose of which are to force the distribution of corporate earnings through the threat of a penalty tax on the corporation.¹¹⁰ Its complex provisions are outside the scope of this paper.

VII. PROPOSED AMENDMENTS

According to a statement in an American Bar Association report, "[i]t now appears probable that public investment in real estate ventures will in the future be primarily through REITs."¹¹¹ With this in mind the committee on real estate problems studied the REIT regulations and determined that certain amendments were in order.

Since 90 percent of the REIT's ordinary income must be distributed as dividends,¹¹² an organization which believed itself to be a REIT, but was later determined not to be, would be subject to the corporation tax at approximately 50 percent on its taxable income. It would have distributed 90 percent to shareholders, thus making charges against income of 140 percent. The severity of such a penalty is on a newly formed association, not yet well-established financially. The impact of the penalty would be felt most by the public investors, not by the managing trustees or promoter group which was responsible for the problem. The computation of income from real estate depends on a host of value judgments to be made by those trustees, the most critical of which is depreciations.

The proposal requires that a full tax be paid on the entire amount of the adjustment in taxable income which creates the underdistribution, and also that an amount equal to the additional income as so determined

Main-Hammond Land Trust, 200 F.2d 308 (6th Cir. 1952), where a land trust was taxed as a corporation.

108. IRC § 1371(a)(1).

109. IRC § 856(a)(5).

110. J. CHOMMIE, *FEDERAL INCOME TAXATION* § 198 (1968).

111. *Report of the Committee on Real Estate Tax Problems—Legislative Recommendations*, *supra* note 86, at 120. [Hereinafter cited as ABA Report].

112. IRC § 857(a)(1).

be distributed to the shareholders.¹¹³ This is somewhat analogous to a deficiency dividend under section 547.¹¹⁴

The type of income required is another problem area which can produce disastrous financial results in the event of accidental disqualification. Ordinarily, income will be from rents. But because of definitional problems, especially as to the independent contractor, it is quite possible that amounts in good faith believed to be rents from real property might subsequently be determined not to be within this category.¹¹⁵ Except in the largest trusts, the 10-percent restricted category would be increased beyond its limits; and this error in classification could lead to disqualification of an entire operation and an excessive penalty.

An alternative penalty proposed by the American Bar Association, which would meet Congressional objectives to avoid pass-through taxation for active business operations, is to impose a regular corporate tax only on the disqualifying income.¹¹⁶ The trust could easily be split into qualified and unqualified portions. Thus, the non-offending income would be taxed only once—in the hands of the shareholders. This proposal would also allow an abatement, credit, or refund to a REIT if, as a result of adjustments by the Internal Revenue Service, distributions which were reported as dividends by stockholders when received in fact exceeded the available earned surplus of the REIT and thus were not taxable as income.¹¹⁷

VIII. THE MARKET

The REIT has demonstrated considerable financial success, in spite of a somewhat shaky beginning which many onlookers thought to be caused by the burdensome regulations.¹¹⁸ "Phoenix-like, the best of the trusts have risen from the ashes, more firmly established than ever; together with new models, they offer an array of under-valued assets, recapitalization potential and income tax shelters."¹¹⁹ According to a recent article in *Barron's*,¹²⁰ the reasons for the market's new look at the REIT are obvious. Investors are now searching for inflationary hedges, one of the best of which is land ownership. And while real property has great value as a source of income, the retirement of mortgages against it serves to increase the owner's stake in its inflation-spiraling equity. Therefore, a conservative REIT which has been reducing its debt while at the same time having its book value reduced through depreciation has

113. ABA Report, *supra* note 86.

114. *Id.* Section 547 of the Code provides that a taxpayer may deduct dividends paid by the corporation after the Service determines that the taxpayer is liable for personal holding company tax.

115. See p. 161 *supra*.

116. ABA Report, *supra* note 86.

117. *Id.*

118. Gilles, *The Scarcity of Capital for Mortgage Lending in California: An Economic or Legal Problem?*, 9 U.C.L.A. L. REV. 545 (1962).

119. Thomas, *supra* note 67, at 48.

120. *Id.*

a substantial hidden asset in the actual market worth of that rising equity.¹²¹

Equity trusts have concentrated their holdings in properties bearing leases with prime tenants, such as shopping centers, apartment buildings, modern office buildings, and buildings in industrial parks.¹²² On the other hand, mortgage trusts have thrived during this time of tight money, changing their lending policies in accordance with the exigencies of the money market.¹²³

IX. CONCLUSION

The REIT concept has undoubtedly gone further than the congressional purpose—to grant real estate trusts substantially the same type of conduit treatment as the regulated investment company, to increase opportunity for the small investor in real estate, and to encourage real estate investment in general.¹²⁴ The result has been to provide a tax windfall to one segment of the investing public. Whether the concept has in fact channeled investment capital away from other potential uses into real estate is not easily determined, especially in light of the many conversions of pre-existing real estate associations.

In this writer's opinion, the REIT presents a financial solution to our requirements for vast complexes of buildings at our population centers. The REIT therefore provides our increasingly complex society with a means by which the capitalistic system of private land ownership can develop at a pace demanded by our population growth and its concomitant needs.

121. The oldest and most venerable trust of all, Real Estate Investment Trust of America (REITA), is also the most conservative. It reinvests its tax-free cash flow in equity to increase book value. Its ratio of long-term debt to net book value of real estate assets is only 29 percent.

A more radical trust, Mutual Real Estate Investment Trust, buys all white-inhabited apartment buildings. A typical deal involves one-third cash and two-thirds debt in a first mortgage. After the purchase, the trustees work in cooperation with local negro community leaders to integrate the building on a non-quota system.

A financially radical trust, Prudent Resources Trust, is quickly applying all imaginable devices to increase return to shareholders. It is uniquely bound by its charter to pay investors a return of capital from cash flow. It has been buying oil and gas wells (as part of the 25 percent of gross income allowed from non-realty) to take advantage of the depletion allowance.

Other individualistic trusts are the Kavanau Real Estate Investment Trust, which specializes in acquisitions through sale and leaseback arrangements, and the B. F. Saul Real Estate Investment Trust, which invests in conservative real property and mortgages and maintains a revolving fund for the purpose of creating its own market—an open-ended trust. *Id.*

122. *Id.*

123. Courshon, *Second Look at Mortgage Investment Trusts*, THE MORTGAGE BANKER, Jan., 1966, at 32.

124. H.R. Doc. No. 12559, 86th Cong., 2d Sess. 10960 (1960).